Public Policy Issues Raised by the Report of the Lehman Bankruptcy Examiner

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Remarks
of Representative Anna G. Eshoo

During the Committee on Financial Services Hearing:

"Public Policy
Issues Raised by the Report of the Lehman Bankruptcy Examiner"

Remarks as
Prepared

Mr. Chairman and Members of the Committee, thank you for inviting me to testify today. I particularly want to thank you for your extraordinary leadership in helping to steer our nation out of the worst financial crisis since the Great Depression.

This hearing on the public policy issues raised by the report of the Lehman bankruptcy Examiner continues to demonstrate your vigilance on behalf of the American people.

Up until days before its declaration of bankruptcy, Lehman Brothers was considered one of the most trusted, reliable, and safest of firms to invest in. The Examiner's report clarifies just how risky the practices and lack of transparency that sank Lehman really were. This behavior exemplifies Wall Street's reckless behavior which brought our economy to the brink of ruin. When we look at the case of Lehman, we are really examining the root causes of the crisis.

We learned in the Examiner's report that:

PAGE 732 - "Lehman employed off-balance sheet devices, known within Lehman as "Repo105" and "Repo 108" transactions, to temporarily remove securities inventory from its balance sheet, usually for a period of seven to ten days, and to create a materially misleading picture of the firm's financial condition in late 2007 and 2008." "Lehman accounted for Repo 105 transactions as "sales" as opposed to financing transactions....By recharacterizing the Repo

105 transaction as a "sale," Lehman removed the inventory from its balance sheet."

PAGE 733 - "Lehman regularly increased its use of Repo 105 transactions in the days prior to reporting periods to reduce its publicly reported net leverage and balance sheet. Lehman's periodic reports did not disclose the cash borrowing from the Repo 105 transaction - i.e., although Lehman had in effect borrowed tens of billions of dollars in these transactions, Lehman did not disclose the known obligation to repay the debt."

Why did Lehman do this?
Let me quote the Examiner's report again:

PAGE 735 - "Starting in mid-2007, Lehman faced a crisis: market observers began demanding that investment banks reduce their leverage. The inability to reduce leverage could lead to a ratings downgrade, which would have had an immediate, tangible monetary impact on Lehman."

PAGE 738 - "By engaging in Repo 105 transactions and using the cash borrowings, Lehman reduced its reported leverage ratios."

PAGE 739 - "In this way, unbeknownst to the investing public, rating agencies, Government regulators, and Lehman's Board of Directors, Lehman reverse engineered the firm's net leverage ratio for public consumption."

Senior executives at Lehman were fully aware of this.
The Examiner's report further states:

PAGES 742-743 - "A senior member of Lehman's Finance Group considered Lehman's Repo 105 program to be balance sheet "window-dressing" that was "based on legal technicalities." Other former Lehman employees characterized Repo 105 transactions as an "accounting gimmick" and a "lazy way of managing the balance sheet."

The bottom line is that despite senior management knowing full well the perilous situation they were getting themselves and their investors into, they kept moving forward.
The Examiner concludes:

PAGE 746 - "Repo 105 transactions were not used for a business purpose, but instead for an accounting purpose: to reduce Lehman's publicly reported net leverage and net balance sheet."

PAGE 853 - "In order for this off-balance sheet device to benefit Lehman, the firm had to conceal information regarding its Repo 105 practice from the public."

With Lehman Brothers engaged in such risky behavior, this begs the question: Where were the SEC, the Treasury, and the Federal Reserve? The Examiner's report concludes that these three agencies were monitoring the situation since early 2007. They were aware that Lehman was in trouble given their highly-leveraged balance sheets.
The agencies warned the firm about the risk of collapse if they did not move to more conservative investments.
However, the leadership at Lehman Brother's continued to maintain their pattern of deception. The Examiner's report goes on to say:

PAGES 1482-1483 - "At the highest levels, each of these agencies recognized - as early as 2007 but certainly by mid-March 2008, after the Bear Stearns near collapse - that Lehman could fail. Treasury Secretary Paulson, Fed Chairman Bernanke, FRBNY President Geithner and SEC Chairman Cox all had direct communication with (former Lehman CEO) Fuld. The day after Bear Stearns Weekend, teams of Government monitors from the SEC and FRBNY were dispatched to, and took up residence at Lehman to review and monitor its financial condition."

PAGE 1482 - "When the Examiner questioned Lehman executives and other witnesses about Lehman's financial health and reporting, a recurrent theme in their responses was that Lehman gave full and complete financial information to Government agencies, and that the Government never raised significant objections or directed that Lehman take any corrective action."

So, we had one of the largest banks in our nation teetering on the brink of bankruptcy. The executives of that bank were masking accounting gimmicks that inflated their quarterly earnings. The agencies responsible for monitoring these banks, specifically the SEC, were taking a hands-off approach when it came to regulation.

The rest of the story we know all too well.

Lehman Brothers was forced to declare bankruptcy, and left a trail of devastation in its wake.

In my Congressional District, San Mateo County and its public institutions were severe victims and still are of the Lehman Brothers bankruptcy.

San Mateo County is required by California State law to hold operating funds, reserves and bond proceeds in an investment pool. Their investment pool which held funds on behalf of the county and local cities, school districts, transit agencies and the community college district, were invested in the most highly-rated, conservative Lehman securities.

When Lehman collapsed, San Mateo County lost $155 million.

As a result, the County and its 735,000 residents are now reeling financially. Teachers are being laid off. Schools are not being built or renovated. Roads are not being improved. Transportation plans are being scrapped, and critical upgrades in public safety have ceased.

The financial plight of San Mateo County was recently profiled in detail in a February 24, 2010, Wall Street Journal article entitled. "Lehman's Ghost Haunts California." Mr. Chairman, I respectfully request that this article be included in the record.

The San Mateo County leaders did nothing wrong. They were not playing the market. They were not rolling the dice to optimize their dollars. They invested in the safest, most conservative instruments. And yet when Lehman Brothers went down, their funds were lost.

It's not only San Mateo County who made the mistake of trusting this institution. More than 40 other municipalities from around the country lost close to $1.7 billion when Lehman collapsed.

Mr. Chairman, we've worked for well over a year now to find a solution for San Mateo County and the other affected counties throughout the country. This work resulted in explicit language in the Emergency Economic Stabilization Act of 2008, which gave the Secretary of the Treasury the authority to purchase the troubled assets held by local governments. In that legislation, Section 103(7) states:

"In exercising the authorities granted in this Act, the Secretary shall take into consideration ...the need to ensure stability for United States public instrumentalities, such as counties and cities, that may have suffered significant increased costs or losses in the current market turmoil..."

I communicated this to Secretary Geithner on multiple occasions. Each time I called to his attention the economic crisis that still exists in San Mateo County and other counties around the nation. Each time I asked him to use his statutory authority to provide them relief. Each time, the Secretary has refused to use TARP funds to assist these localities.

The amount of TARP funds that could be used to assist the municipalities affected by the Lehman collapse is miniscule compared to the hundreds of billions of dollars the Treasury Department has provided to banks. The $1.7 billion these municipalities lost represents one-quarter of 1% of TARP funds.

In his most recent letter to me on March 11th the Secretary said, "I appreciate your concern. However, Treasury does not intend to make purchases of Lehman Brothers securities from public instrumentalities."

This
is where I must reference the Examiner's report again. On page 1504, when referring to an interview with Federal Reserve Chairman Bernanke, the Examiner says:

PAGE 1504 - "Bernanke noted that, after
passage of the TARP legislation, the Treasury had authority to inject capital directly into institutions: "If we had that [TARP] authority on September 14, we would have been able to save [Lehman], no question about it."

Congress
has since vested the Secretary with the authority to correct the harm done, but he has chosen not to exercise it.

Let's
fast forward to today. We now know that the
federal government is earning billions of dollars in profits from the sale of the troubled assets. In a March 29,
2010, AP article I also request be submitted for the record, it was reported that the federal government will receive $7.5 billion from the sale of the 27 percent stake in Citi they now have. To
date, the federal government has already earned $15.4 billion from dividends, interest, and the sale of bank stock.

These
transactions will total more than TEN times the amount of money that all the counties in the country lost with the Lehman collapse.

I
believe it's time for the federal government to do for local governments what we've done for big banks.

I'm
introducing legislation that will require portions of these profits
coming into the Treasury from the sale of their interests in financial institutions to be used to provide relief to counties affected by the Lehman collapse.

It
will clarify a way for the federal government to assist local governments impacted by the Lehman collapse.

At a
time when saving those institutions which were deemed "too big to fail," we shouldn't
overlook those who are being treated as though they are too small to help.

It's
time to serve the best interests of the American people. They lost their taxpayer dollars which they
intended to be invested in their community for vital services.

Thank you, Mr. Chairman and Members of the Committee. I look forward to partnering with you and my
good friend and colleague Congresswoman Speier in moving my legislation forward
to assist the public agencies who trusted Lehman, invested hard-to-come-by tax
dollars, only to see them evaporate. The
Examiner's report describes in excruciating detail the shocking condition of
Lehman Brothers, yet nothing was done.
My abiding hope is that we will make this right by not only legislating
reforms so it can never happen again, but also by assisting our public
institutions who are required to carry out their responsibilities to our mutual
constituents.